DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 00-0194
Financial Institutions Tax
For the Years 1995, 1996, and 1997

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Combining Taxpayer's Bank Group and Financial Group Into a Single Unitary Return – Financial Institutions Tax.

Authority: IC 6-5.5-1-18; IC 6-5.5-6-1; 45 IAC 17-2-1(a); 45 IAC 17-3-5(a); 45 IAC 17-3-5(c).

Taxpayer maintains that the audit erred in requiring that its bank group and financial group file a single unitary return. Taxpayer argues that the two groups operate independently of each other and are entitled to file two combined unitary returns.

II. Calculation of Taxpayer's Foreign Source Income – Exclusion of Related Expenses.

Authority: IC 6-5.5-1-2(a); IC 6-5.5-1-2(a)(2)(B); IC 6-8.1-5-1(b).

Taxpayer argues that expenses related to the acquisition of its foreign source income should not be deducted from that foreign source income.

III. Calculation of Taxpayer's Receipts Factor.

Authority: IC 6-5.5-2-4; 45 IAC 17-3-5(a), (c).

Taxpayer maintains that the audit erred in making adjustments to the numerator and denominator of its receipts factor. Taxpayer requests that the Department restore the separate apportionment factor calculation for its bank group and financial group and that the Department eliminate the receipts factor adjustments which result – according to taxpayer – in a double-counting of certain receipts factor items.

IV. Neighborhood Assistance Credit Carryforward.

Authority: IC 6-3.1-9 et seq.; IC 6-3.1-9-6.

Taxpayer argues that the Department erred when it denied permission for the taxpayer to carry forward a neighborhood assistance credit, approved in 1994, but claimed by the taxpayer in 1995.

V. Disallowance of Enterprise Zone Loan Interest Credit.

Authority: IC 6-3.1-10 et seq.

According to taxpayer, the Department erred in disallowing Enterprise Zone Loan Interest Credits on the ground that the taxpayer had provided insufficient detail to substantiate that the interest was obtained from qualifying loans made within a state enterprise zone.

VI. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer argues that the Department was not justified in assessing the ten-percent negligence penalty. Accordingly, the taxpayer requests that the Department exercise its discretion to abate that penalty.

STATEMENT OF FACTS

Taxpayer is a diversified financial services company operating what it identifies as a "corporate group" and a "financial group." The corporate group (hereinafter "bank group") provides traditional bank services, is insured by the FDIC, and is subject to oversight by the Office of the Comptroller of the Currency. The financial group provides similar services to those consumers who may not be qualified to obtain those services from a traditional banking institution.

Taxpayer provides its subsidiaries various services including planning, asset management, investment administration, advertising, and certain personnel services. Taxpayer derives its income from investments in, and advances to, these and other subsidiaries. For federal purposes, the taxpayer filed a consolidated return which included all its subsidiaries.

For purposes of Indiana's Financial Institutions Tax, the bank group and the financial group filed two combined unitary returns. During the audit, an adjustment was made to combine both the bank group and the financial group. Taxpayer disagreed with that particular adjustment and with certain other audit adjustments. Taxpayer submitted a protest, an administrative hearing was conducted, and this Letter of Findings followed as a result.

DISCUSSION

I. Combining Taxpayer's Bank Group and Financial Group Into a Single Unitary Return – Financial Institutions Tax.

Indiana imposes an excise tax known as the Financial Institutions Tax (FIT) on all entities determined to be "transacting the business of a financial institution in Indiana." 45 IAC 17-2-

1(a). The taxpayer subject to the FIT must adopt the combined/unitary reporting method unless the taxpayer is not a member of a unitary group. In such an instance, a separate (single-entity) reporting method is required. For those taxpayer which are members of a unitary group, the combined return must cover "all the operations of the unitary business and including all taxpayer members of the unitary group." 45 IAC 17-3-5(a).

The audit determined that taxpayer's commonly owned bank group and financial group were required to file a single unitary return. The audit based that decision on the fact that taxpayer owned more than 50 percent of its subsidiaries' stock.

The audit's decision was predicated upon IC 6-5.5-6-1, which states that "taxpayer members of a unitary group are required to file only one (1) return covering all members of the unitary group." The resolution of taxpayer's first protest item rests on whether taxpayer's bank group and financial group were members of a unitary business.

45 IAC 17-3-5(c) states that, "A 'unitary business' means business activities or operations that are of mutual benefit, dependent upon, or contributing to one another, individually as a group, in transacting the business of a financial institution." The regulation explains that, "Unity is presumed whenever there is a unity of ownership, operation, and use evidenced by centralized management or executive force, centralized purchasing, advertising, accounting, or other controlled interaction among entities that are members of a unitary group." Id.

Taxpayer bases its protest on the regulation cited above in particular, "Unity is presumed whenever there is a unity of ownership, operation, *and* use . . . ." 45 IAC 17-3-5(c) (*Emphasis added*) *See also* IC 6-5.5-1-18. Taxpayer readily admits that the bank group and the financial group exhibit unity of ownership because both groups are owned by the taxpayer. However, taxpayer maintains that the conjunctive "and" requires that a "three-unities" test be met in order to establish that the bank group and financial group are members of the same "unitary business." Therefore, according to taxpayer, because the Department has failed to establish that there is anything more than common ownership between the two entities, the bank group and financial group are entitled to file separate FIT returns.

To that end, taxpayer presents much evidence purportedly establishing that the bank group and the financial group are identifiably distinct and operationally independent of one another. The financial group maintains a separate out-of-state headquarters. The financial group is independent and self-supporting because it has its own corporate staff. The financial group has its own staff of attorneys to address its unique legal needs. The financial group has its own human resources group, treasury management staff, information services division, printing and shipping facilities, and its own marketing department. According to taxpayer, there is no flow of assets between the bank group and the financial group. Therefore, in the absence of operational integration, flow of value, or common management, the groups are entitled to file submit separate FIT returns.

However, taxpayer ignores the unrefuted conclusions set out in the audit report. That report stated that taxpayer provided each of its subsidiaries various services including strategic planning, asset and liability management, investment administration, portfolio planning, tax

planning, new product and business development, advertising, administrative and audit services, employee services and payroll management. Taxpayer's 1996 annual report stated that taxpayer received 23 percent of its earnings from the financial group. Taxpayer's 1996 and 1997 corporate reports both emphasize that its diversified business structure – including both the bank group and financial group – enables it to meet the changing needs of its customers while simultaneously preserving the taxpayer's overall financial condition despite fluctuations in earnings amongst its different groups.

Even granting the legitimacy of taxpayer's "three-unities" test, a cursory examination of taxpayer's business operations provides sufficient indicia to establish "a unity of ownership, operation, and use." 45 IAC 17-3-5(c). Although the bank group and the financial may be distinct branches, they are nonetheless branches of the same tree. The bank group and the financial group together contribute to taxpayer's overall financial well-being and are each dependent upon and sustained by that well-being. As taxpayer succinctly puts it, "The diversity of our business enables us to rely on different streams of earnings as economic cycles and customer preferences change. Our goal is simple: earn 100 percent of every creditworthy customer's business." Taxpayer's 1997 Annual Report.

Taxpayer views the bank group and the financial group as operating in a vacuum each entirely independent of one another. However, the evidence indicates that the two entities operate to sustain and preserve the taxpayer's common economic well-being. Hence, the two entities function to "contribut[e] to one another, individually as a group, in transacting the business of a financial institution." 45 IAC 17-3-5(c).

FINDING

Taxpayer's protest is respectfully denied.

II. Calculation of Taxpayer's Foreign Source Income – Exclusion of Related Expenses.

Taxpayer protests the audit's decision to reduce the taxpayer's amount of taxpayer's foreign source income exclusion.

In calculating the amount of foreign source dividends taxpayer was entitled to deduct from its federal adjusted gross income, the audit reduced the amount of foreign source dividends by 15 percent. The 15 percent deduction represented an estimate of the expenses taxpayer incurred in acquiring the foreign source dividends.

In calculating taxpayer's state FIT liability, the starting point is the taxpayer's federal adjusted gross income. IC 6-5.5-1-2(a) states that, "Except as provided in subsections (b) through (d), 'adjusted gross income' means income as defined in Section 63 of the Internal Revenue Code . . . ."

However, the taxpayer is entitled to exclude certain income from the amount of its federal adjusted gross income. Specifically, IC 6-5.5-1-2(a)(2)(B) permits the taxpayer to subtract

"Income that is derived from sources outside the United States, as defined by the Internal Revenue Code."

Therefore, the taxpayer does not have to pay the FIT on "foreign source income." However, the amount of "foreign source income" the taxpayer may subtract from its federal adjusted gross income is not unrestrained. The Department requires the taxpayer to add back to its "foreign source income" those expenses related to obtaining that "foreign source income." The Department's rationale for doing so is plain; if Indiana starts with federal taxable income – an amount arrived at by deducting all relevant business expenses – but allows a straightforward deduction of the taxpayer's foreign source income, then the taxpayer, in effect, is receiving a double deduction of the expenses related to that foreign source income.

Taxpayer challenges the audit's deduction of the expenses on two grounds: First, taxpayer argues that there is no statutory or regulatory basis on which to permit an expense adjustment in tandem with the exclusion for foreign income and that the audit's proposed adjustment goes beyond the scope of the statute; Second, taxpayer maintains that even if some expense disallowance were appropriate, the method used by the audit overstates the amount of the expenses.

The taxpayer's facial challenge to the Department's practice of deducting from its "foreign source income" those expenses related to the acquisition of that income, does not survive close scrutiny. In calculating – for purposes of the FIT – taxpayer's adjusted gross income, the taxpayer has provided no justification for allowing it to effectively "deduct" its expenses two times over. Such a proposed methodology finds no basis either in law or common sense.

Taxpayer's secondary argument must also be rejected. Taxpayer maintains that the 15 percent estimate "is not a reasonable allocation of expense deductions to the income that the expense generates [and that] it constitutes impermissible taxation of income and should be thrown out." Even if taxpayer is correct, it has offered nothing specific to refute the audit's conclusion that the 15 percent figure reasonably reflects expenses related to acquiring the foreign source income. "The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." IC 6-8.1-5-1(b). Taxpayer has done nothing to meet that burden.

FINDING

Taxpayer's protest is respectfully denied.

III. Calculation of Taxpayer's Receipts Factor.

In reviewing taxpayer's FIT calculations, the audit adjusted the numerator of the receipts factor to include the financial group. The audit also adjusted the denominator of the receipts factor to include the financial group and to include various other adjustments.

The taxpayer has challenged these audit adjustments. Specifically, taxpayer disagreed with the decision combining the bank group and financial group receipts into a single apportionment factor.

As already determined within this Letter of Findings, it was entirely appropriate, under 45 IAC 17-3-5(a), (c), for the audit to require that the bank group and the financial group submit a single combined return. Having correctly made that determination, there is nothing to indicate that the audit erred in designating and apportioning taxpayer's receipts according to the dictates of IC 6-5.5-2-4.

However, the taxpayer also challenges the audit adjustments citing what it refers to as inadvertent "double-account[ing] for a few items." In particular, taxpayer asserts that a mortgage adjustment to the financial group's numerator double-counts receipts already accounted for in the bank group's factor.

To the extent that taxpayer maintains that the audit made computational errors, taxpayer's protest is sustained. The supplemental audit is requested to verify and, if necessary, to make the necessary corrections.

FINDING

Taxpayer's protest is denied in part and – subject to verification by the supplemental audit – is sustained in part.

IV. Neighborhood Assistance Credit Carryforward.

One of taxpayer's banks was approved for a $750 Neighborhood Assistance Credit in 1994. The bank group was unable to use the $750 credit in 1994 because the bank group reported a net operating loss. In 1995, the bank was approved for an additional $5,000 in Neighborhood Assistance Credits. The taxpayer "carried over" the unused $750 credit to 1995 and claimed $5,750 in credits. The audit disallowed $750 of that credit because taxpayer had only received approval for the $5,000 1995 credit.

Taxpayer argues that it should be allowed to carry over the unused $750 credit to 1995.

There is no provision in the relevant law, IC 6-3.1-9 et seq., permitting a Neighborhood Assistance Credit grantee to carry forward the credit to a succeeding year. The taxpayer was granted permission to claim a $750 credit during 1994, but 1994 passed and the taxpayer had failed to claim the credit. For all practical purposes, the $750 credit expired on December 31, 1994. IC 6-3.1-9-6 specifically states that "[a] tax credit shall be allowable under this chapter only for the taxable year of the taxpayer in which the contribution qualifying for the credit is paid or permanently set aside in a special account for the approved program or purpose."

As set out in Information Bulletin Number 22, September 1997, "There is no provision for carry back, carry forward, or refund of the credit."

FINDING

Taxpayer's protest is respectfully denied.

V. Disallowance of Enterprise Zone Loan Interest Credit.

The audit disallowed the Enterprise Zone Loan Interest Credits claimed by one of taxpayer's banks. The audit disallowed the credits on the ground that it could not verify that the loans were made to entities located within the Ft. Wayne Enterprise zone. In its protest, taxpayer disagreed with the disallowance of the credits.

Taxpayer presented a list of entities having Ft Wayne addresses. According to taxpayer, this list represents "most of the claimed enterprise zone loans."

Under the assumption that taxpayer can directly relate the claimed credits to individual enterprises located within the Ft. Wayne enterprise zone, and that the loans represent a "qualified investment" under IC 6-3.1-10 et seq., taxpayer's protest is sustained subject to the findings of the supplemental audit.

FINDING

Taxpayer's protest is sustained subject to the determinations of the supplemental audit.

VI. Abatement of the Ten-Percent Negligence Penalty.

Taxpayer protests the assessment of the ten-percent negligence penalty on the amount of tax deficiency determined by the Department. Taxpayer maintains that any errors it made in determining its state tax liabilities was not due to willful neglect.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer has presented information sufficiently adequate to support its contention that any errors it made in determining its FIT liabilities were not due to willful neglect.

FINDING

Taxpayer's protest is sustained.

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